

Part III

Administrative, Procedural, and Miscellaneous

26 CFR 1.199-2: Wage Limitation (Also: 26 CFR 1.199-2T)

Methods of Determining Paragraph (e)(1) Wages for Purposes of the §199(b)(1) Wage Limitation on the §199 Deduction

Rev. Proc. 2006-47

SECTION 1. PURPOSE

This revenue procedure provides methods used as part of calculating W-2 wages for purposes of §199(b)(1) of the Internal Revenue Code, which limits the amount of the §199 deduction for income attributable to domestic production activities to 50 percent of the W-2 wages of the taxpayer for the taxable year.

Section 514(a) of the Tax Increase Prevention and Reconciliation Act of 2005 (Public Law 109-222) (TIPRA) imposes a new limitation on W-2 wages for purposes of §199 for taxable years beginning after May 17, 2006. Under the change made by TIPRA, W-2 wages, for purposes of §199, include only amounts that are properly allocable to domestic production gross receipts (DPGR) for purposes of §199(c)(1).

Thus, to determine such W-2 wages for taxable years beginning after May 17, 2006, it is necessary to determine the amount that would have been W-2 wages for purposes of §199 before the amendment by TIPRA and then to determine the portion of that amount properly allocable to DPGR.

This revenue procedure provides methods for calculating the amount of wages described in §1.199-2(e)(1) of the Income Tax Regulations (“paragraph (e)(1) wages”). Section 1.199-2T(e)(2) of the temporary Income Tax Regulations provides that the term W-2 wages includes only paragraph (e)(1) wages that are properly allocable to DPGR for purposes of §199(c)(1). Thus, for taxable years covered by this revenue procedure, a taxpayer first determines the amount of paragraph (e)(1) wages under this revenue procedure and then applies §1.199-2T(e)(2) to determine the amount of W-2 wages.

Section 1.199-2(e)(3) of the regulations provides the Internal Revenue Service with authority to issue guidance providing the methods that may be used to calculate W-2 wages. Section 1.199-2(e)(3) is effective for taxable years beginning on or after June 1, 2006. In Rev. Proc. 2006-22, 2006-23 I.R.B. 1033, the Internal Revenue Service provided methods for calculating W-2 wages for taxpayers who choose to apply the final regulations to taxable years beginning before June 1, 2006, but only for taxable years beginning on or after January 1, 2005, and on or before May 17, 2006. For taxable years covered by this revenue procedure, this revenue procedure provides methods to determine paragraph (e)(1) wages, but taxpayers must then subject such wages to the limitation contained in §1.199-2T(e)(2) of the temporary regulations to determine W-2 wages.

SECTION 2. BACKGROUND

Section 199(a) provides a deduction for an amount equal to a percentage of the lesser of (A) the qualified production activities income of the taxpayer for the taxable year, or (B) taxable income (determined without regard to §199) for the taxable year (or, in the case of an individual, adjusted gross income).

Section 199(b)(1) provides that the amount of the deduction allowable under §199(a) for any taxable year shall not exceed 50 percent of the W-2 wages of the taxpayer for the taxable year. For this purpose, §199(b)(2)(A) defines the term “W-2 wages” to mean, with respect to any person for any taxable year of such person, the sum of the amounts described in §6051(a)(3) and (8) paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year. Section 199(b)(2)(C) provides that W-2 wages shall not include any amount that is not properly included in a return filed with the Social Security Administration (SSA) on or before the 60th day after the due date (including extensions) for such return.

Section 514(a) of TIPRA added §199(b)(2)(B) to exclude from the term W-2 wages any amount that is not properly allocable to domestic production gross receipts for purposes of §199(c)(1). Section 199(b)(2)(B) is effective with respect to taxable years beginning after the date of enactment, May 17, 2006. Temporary and final regulations have been issued to reflect the changes in the definition of W-2 wages made by TIPRA. Section 1.199-2T(e)(2) of the temporary regulations provides rules for applying the TIPRA limitation on W-2 wages under §199(b)(2)(B).

This revenue procedure provides three methods for calculating paragraph (e)(1) wages. These methods for calculating paragraph (e)(1) wages are generally similar to the methods used to calculate W-2 wages before the amendment made by TIPRA as set forth in Rev. Proc. 2006-22, §1.199-2 of the proposed regulations that were published in the **Federal Register** on November 4, 2005 (70 FR 67220), and section 4.02 of Notice 2005-14, 2005-1 C.B. 498, 514. The first method (the unmodified Box method) allows for a simplified calculation while the second and third methods (the modified Box 1 method and the tracking wages method) provide greater accuracy. After paragraph (e)(1) wages are determined under one of these methods, the amount of W-2 wages is then determined by applying §1.199-2T(e)(2) of the temporary regulations.

SECTION 3. RULES OF APPLICATION

.01 *In general.* Except as provided in section 3.03 and section 6.01 of this revenue procedure, the Forms W-2, "Wage and Tax Statement," used in determining the amount of paragraph (e)(1) wages are those issued for the calendar year ending during the taxpayer's taxable year for wages paid to employees (or former employees) of the taxpayer for employment by the taxpayer. For this purpose, employees of the taxpayer are limited to employees of the taxpayer as defined in §3121(d)(1) and (2) (that is, officers of a corporate taxpayer and employees of the taxpayer under common law rules). See §1.199-2(a)(1) of the regulations.

.02 *Wages paid by entity other than common law employer.* In determining paragraph (e)(1) wages, a taxpayer may take into account wages paid by another entity

and reported by the other entity on Forms W-2 with the other entity as the employer listed in Box c of the Forms W-2, provided that the wages were paid to employees of the taxpayer for employment by the taxpayer. If the taxpayer is treated as an employer described in §3401(d)(1) because of control of the payment of wages (that is, the taxpayer is not the common law employer of the payee of the wages), the payment of wages may not be included in determining paragraph (e)(1) wages of the taxpayer. If the taxpayer is paying wages as an agent of another entity to individuals who are not employees of the taxpayer, the wages may not be included in determining the paragraph (e)(1) wages of the taxpayer. See §1.199-2(a)(2) of the regulations.

.03 Requirement that wages must be reported on return filed with Social Security Administration. Paragraph (e)(1) wages shall not include any amount that is not properly included in a return filed with SSA on or before the 60th day after the due date (including extensions) for such return. For this purpose, if a Form W-2c (or corrected return) is filed to correct a Form W-2 that was not filed with SSA on or before the 60th day after the due date (including extensions) of the Form W-2 (or to correct a Form W-2c relating to a Form W-2 that had not been filed with SSA on or before the 60th day after the due date (including extensions) of the Form W-2), then such Form W-2c (or corrected return) shall not be considered to have been filed with SSA on or before the 60th day after the due date (including extensions) for such Form W-2c (or corrected return), regardless of when such Form W-2c (or corrected return) is filed. See §1.199-2(a)(3) of the regulations for further guidance related to this requirement.

.04 No application in determining whether amounts are wages for employment tax purposes. The discussions of “wages” in this revenue procedure and in the regulations under §199 are for purposes of §199 only and have no application in determining whether amounts are wages under §3121(a) for purposes of the Federal Insurance Contributions Act, under §3306(b) for purposes of the Federal Unemployment Tax Act, or under §3401(a) for purposes of the Collection of Income Tax at Source on Wages (federal income tax withholding), or any other wage-related determination. See §1.199-2(a)(1) of the regulations.

.05 Application for a taxpayer with a short taxable year. Subject to the other rules of application of the regulations and of this revenue procedure, paragraph (e)(1) wages of the taxpayer for a short taxable year shall include those wages paid during the short taxable year to employees of the taxpayer as determined under the tracking wages method described in section 5.03 of this revenue procedure. See section 6 of this revenue procedure.

.06 Acquisition or disposition of a trade or business (or major portion). If a taxpayer (a successor) acquires a trade or business, the major portion of a trade or business, or the major portion of a separate unit of a trade or business from another taxpayer (a predecessor), then, for purposes of computing the respective section 199 deduction of the successor and of the predecessor, paragraph (e)(1) wages paid for that calendar year shall be allocated between the successor and the predecessor based on whether the wages are for employment by the successor or for employment by the

predecessor. Thus, in this situation, paragraph (e)(1) wages are allocated based on whether the wages are for employment for a period during which the employee was employed by the predecessor or for employment for a period during which the employee was employed by the successor, regardless of which permissible method for Form W-2 reporting is used. See §1.199-2(c) of the regulations.

.07 Non-duplication rules. Amounts that are treated as paragraph (e)(1) wages for a taxable year under any method of calculating paragraph (e)(1) wages shall not be treated as paragraph (e)(1) wages for any other taxable year. Thus, for example, an amount of nonqualified deferred compensation that is treated as paragraph (e)(1) wages under the Unmodified Box Method described in section 5.01 of this revenue procedure shall not be treated as paragraph (e)(1) wages in any other taxable year. Also, an amount shall not be treated as paragraph (e)(1) wages by more than one taxpayer. See section 1.199-2(d) of the regulations.

.08 Trade or business requirement. Pursuant to §1.199-8(c)(1), the term paragraph (e)(1) wages only includes those wages paid to employees of the taxpayer that are attributable to the actual conduct of a trade or business of the taxpayer. For example, remuneration paid to an employee for domestic service performed in the private home of the taxpayer is not included in paragraph (e)(1) wages of the taxpayer.

SECTION 4. DEFINITION OF PARAGRAPH (e)(1) WAGES AND CORRELATION WITH BOXES ON FORM W-2

.01 Definition of paragraph (e)(1) wages. Paragraph (e)(1) wages means, with respect to any person for any taxable year of such person, the sum of the amounts

described in §6051(a)(3) and (8) paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year. See §1.199-1(e)(1) of the regulations. Thus, paragraph (e)(1) wages include: (i) the total amount of wages as defined in §3401(a); (ii) the total amount of elective deferrals (within the meaning of §402(g)(3)); (iii) the compensation deferred under §457; and (iv) for tax years beginning after December 31, 2005, the amount of designated Roth contributions (as defined in §402A).

.02 Correlation with Form W-2. Under the 2006 Forms W-2, the elective deferrals under §402(g)(3) and the amounts deferred under §457 directly correlate to coded items reported in Box 12 on Form W-2. Box 12, Code D is for elective deferrals to a §401(k) cash or deferred arrangement (plan); Box 12, Code E is for elective deferrals under a §403(b) salary reduction agreement; Box 12, Code F is for elective deferrals under a §408(k)(6) salary reduction Simplified Employee Pension (SEP); Box 12, Code G is for elective deferrals and employer contributions (including nonelective deferrals) to any governmental or nongovernmental §457(b) deferred compensation plan; Box 12, Code S is for employee salary reduction contributions under a §408(p) SIMPLE (simple retirement account); Box 12, Code AA is for designated Roth contributions (as defined in section 402A) to a section 401(k) plan; and Box 12, Code BB is for designated Roth contributions (as defined in section 402A) under a section 403(b) salary reduction agreement. However, designated Roth contributions are also reported in Box 1, Wages, tips, other compensation, and Box 5, Medicare wages and

tips, and are subject to income tax withholding.

SECTION 5. METHODS FOR CALCULATING PARAGRAPH (e)(1) WAGES

For any taxable year, a taxpayer must calculate paragraph (e)(1) wages for purposes of §199(b)(1) using one of the three methods described in section 5.01, 5.02, and 5.03 of this revenue procedure. These three methods are subject to the non-duplication rules provided in §1.199-2(d) and in section 3.07 of this revenue procedure. For a taxpayer with a short taxable year, see Section 6 of this revenue procedure. In calculating paragraph (e)(1) wages for a taxable year under the methods below, the taxpayer includes only those Forms W-2 that are for the calendar year ending with or within the taxable year of the taxpayer and that meet the rules of application described in section 3 of this revenue procedure.

.01 Unmodified box method. Under the unmodified box method, paragraph (e)(1) wages are calculated by taking, without modification, the lesser of—

- (A) The total entries in Box 1 of all Forms W-2 filed with SSA by the taxpayer with respect to employees of the taxpayer for employment by the taxpayer; or
- (B) The total entries in Box 5 of all Forms W-2 filed with SSA by the taxpayer with respect to employees of the taxpayer for employment by the taxpayer.

.02 Modified Box 1 method. Under the Modified Box 1 method, the taxpayer makes modifications to the total entries in Box 1 of Forms W-2 filed with respect to employees of the taxpayer. Paragraph (e)(1) wages under this method are calculated as follows—

(A) Total the amounts in Box 1 of all Forms W-2 filed with SSA by the taxpayer with respect to employees of the taxpayer for employment by the taxpayer;

(B) Subtract from the total in paragraph .02(A) of this section amounts included in Box 1 of Forms W-2 that are not wages for Federal income tax withholding purposes and amounts included in Box 1 of Forms W-2 that are treated as wages for purposes of income tax withholding under §3402(o) (for example, supplemental unemployment compensation benefits); and

(C) Add to the amount obtained after paragraph .02(B) of this section the total of the amounts that are reported in Box 12 of Forms W-2 with respect to employees of the taxpayer for employment by the taxpayer and that are properly coded D, E, F, G, and S.

.03 Tracking wages method. Under the tracking wages method, the taxpayer actually tracks total wages subject to Federal income tax withholding and makes appropriate modifications. Paragraph (e)(1) wages under this method are calculated as follows—

(A) Total the amounts of wages subject to Federal income tax withholding that are paid to employees of the taxpayer for employment by the taxpayer and that are reported on Forms W-2 filed with SSA by the taxpayer for the calendar year;

(B) Subtract from the total in paragraph .03(A) of this section the supplemental unemployment compensation benefits (as defined in

§3402(o)(2)(A)) that were included in the total in paragraph .03(A) of this section; and

(C) Add to the amount obtained after paragraph .03(B) of this section the total of the amounts that are reported in Box 12 of Forms W-2 with respect to employees of the taxpayer for employment by the taxpayer and that are properly coded D, E, F, G, and S.

SECTION 6. APPLICATION IN CASE OF SHORT TAXABLE YEAR

.01 Special rule for taxpayers with a short taxable year. In the case of a taxpayer with a short taxable year, subject to the rules of §1.199-2(a), the paragraph (e)(1) wages of the taxpayer for the short taxable year shall include only those wages paid during the short taxable year to employees of the taxpayer, only those elective deferrals (within the meaning of §402(g)(3)) made during the short taxable year by employees of the taxpayer, and only compensation actually deferred under §457 during the short taxable year with respect to employees of the taxpayer. See §1.199-2(b) of the regulations.

.02 Method required for a short taxable year and modifications required in application of method. The paragraph (e)(1) wages of a taxpayer with a short taxable year shall be determined under the tracking wages method described in section 5.03 of this revenue procedure. In applying the tracking wages method in the case of a short taxable year, the taxpayer must apply the method as follows—

(A) For purposes of section 5.03(A), the total amount of wages subject to Federal

income tax withholding and reported on Form W-2 must include only those wages subject to Federal income tax withholding that are actually paid to employees during the short taxable year and reported on Form W-2 for the calendar year ending with or within that short taxable year;

(B) For purposes of section 5.03(B), only the supplemental unemployment compensation benefits paid during the short taxable year that were included in the total in section 5.03(A) as modified by section 6.02(A) are required to be deducted; and

(C) For purposes of section 5.03(C), only the portion of the total amounts reported in Box 12, Codes D, E, F, G, and S on Forms W-2, that are actually deferred or contributed during the short taxable year are included in paragraph (e)(1) wages.

SECTION 7. EFFECTIVE DATE

This revenue procedure applies to taxpayers with taxable years beginning on or after October 19, 2006. A taxpayer may apply this revenue procedure to taxable years beginning after May 17, 2006, and before October 19, 2006. For taxable years beginning after May 17, 2006, a taxpayer may not apply any guidance under section 199 in a manner inconsistent with amendments made to section 199 by section 514 of TIPRA.

SECTION 8. DRAFTING INFORMATION

The principal author of this revenue procedure is Alfred G. Kelley of the Office of Associate Chief Counsel (Tax Exempt & Government Entities). For further information

regarding this revenue procedure contact Mr. Kelley at (202) 622-6040 (not a toll-free call).